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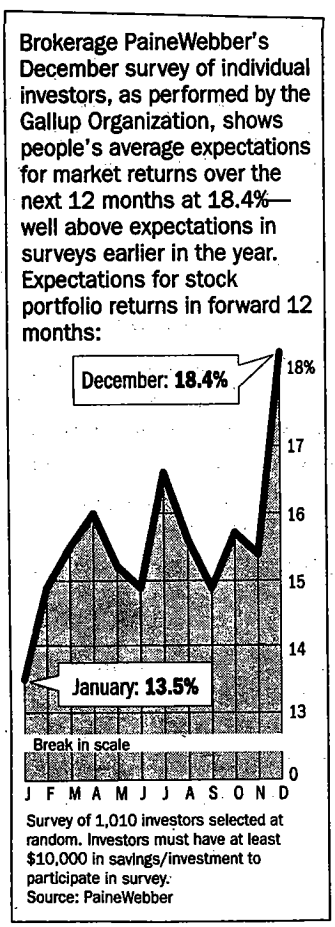
January 19, 2000 **LETTER 1295**

THE MARKET: The most frustrating thing I have to deal with as I write these Letters is that 2,500 of my subscribers are still not on the Internet. Here I am, writing my little heart out each day, and a total of 4,300 of my 6,800 subscribers are signed up for my ABSOLUTELY FREE daily web site. And this when the market is highly volatile and when it's vital to see and understand the market picture on a daily basis (for instance, my PTI gave an "early buy signal" on the week ending January 7). So c'mon, you 2,500 subscribers, move yourselves into the 21st century and get Internet capabilities. It's easy -- and today there are many non-PC ways of doing it. Listen, if at the age of 75 I can learn to write on the web, you can certainly learn to read on the web. You can do it, honest.

"Economists are Euphoric about the Prospects for 2000" headlined the January 3 *WSJ*. As the year 1999 drew to a close, it was the almost unanimous opinion of analysts that the year 2000 is going to be a very good one with corporate profits up as much as 15% -- and with the Dow almost guaranteed to reach 12,500 or better.


Brokerage PaineWebber's December survey of individual investors, as performed by the Gallup Organization, shows people's average expectations for market returns over the next 12 months at 18.4%—well above expectations in surveys earlier in the year.
Expectations for stock portfolio returns in forward 12 months:
December: 18.4%
January: 13.5%
Break in scale
18%
17
16
15
14
13
0
J F M A M J J A S O N D
Survey of 1,010 investors selected at random. Investors must have at least $10,000 in savings/investment to participate in survey.
Source: PaineWebber

As for the stock-buying public, this clip from the January 3 *LA Times* says it all.

And it may happen just the way the analysts and the public expect. At any given time, the stock market can boast a wide collection of experts. But there's only one expert that I trust -- and that expert is **the market itself.** The real story is always in the Averages and the technicals -- the only problem is that our reading of the market data tends to be -- well, less than perfect.

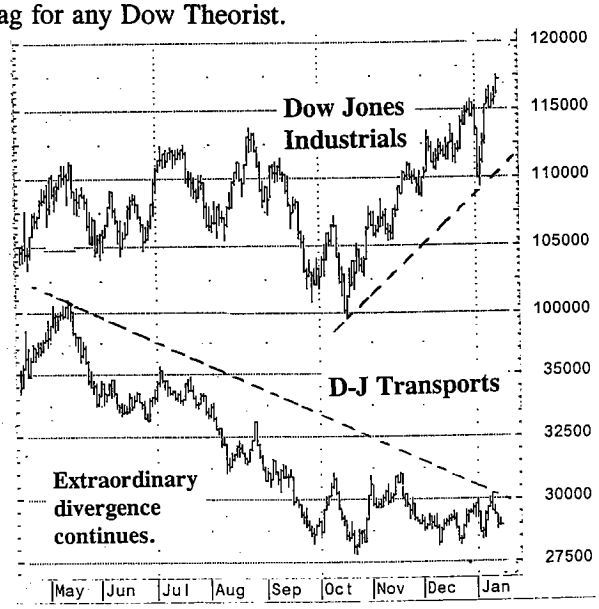
The stock market closed the year 1999 with the biggest collection of anomalies and disparities that I have ever seen -- and most of these are still in place. The S&P was selling at better than 33 times earnings, more than 50% higher than its P/E ratios at the major market tops of 1929 and 1973. Furthermore, the S&P was selling at better than 80 times dividends, a situation never seen before. And the stock market? It has simply ignored it.

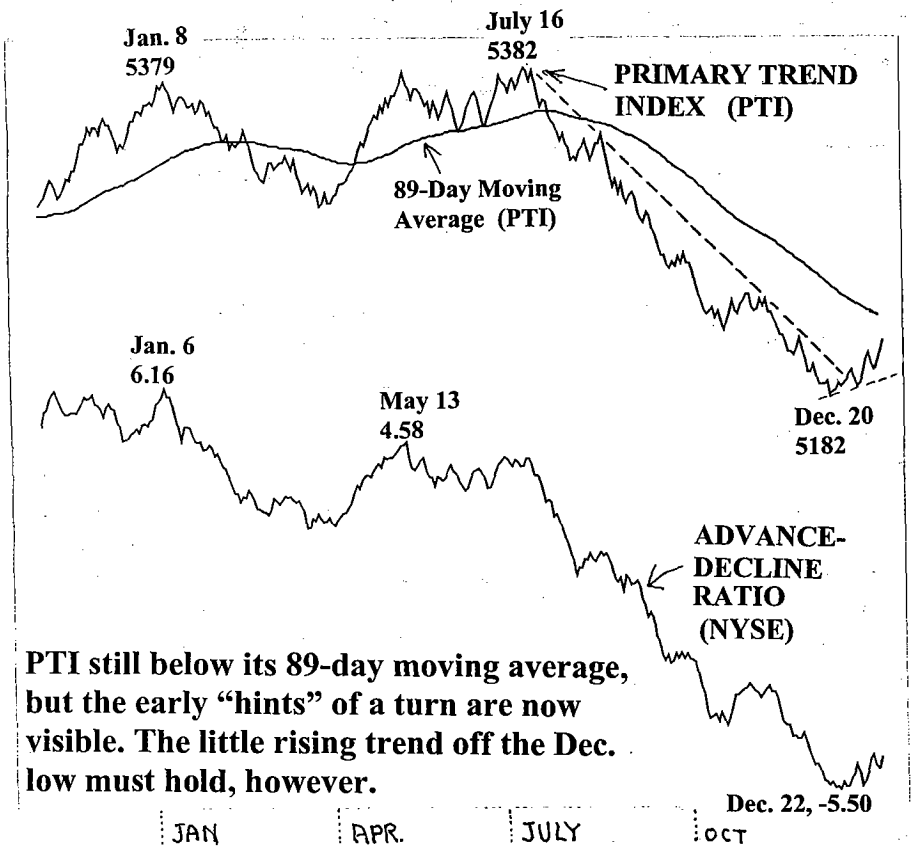
Dec. 31 DJIA 11452.86; PTI 5195; A-D Ratio -4.76
Jan. 7 DJIA 11522.56; PTI 5203; A-D Ratio -4.62
Jan. 14 DJIA 11722.98; PTI 5209; A-D Ratio -4.64
Dow Yield: 1.30%; Dow Price/Earnings: 25.0
Dow Times Book Value: 6.92; PTI 89-day exp. MA: 5231
Percentage of Undervalued Blue-chips: 12%
Gold 34-day MA: 288

During 1999 we saw many new highs in the S&P despite the incredible fact that 60% of all NYSE stocks showed losses for the year 1999 and 74% of NYSE stocks were below their 200-day moving averages and therefore in bearish trends.

The big-cap averages were at or near highs while the breadth (advance-decline lines) of the NYSE, the Nasdaq and the Amex were at or near their lows. This was the greatest disparity between price and breadth in history; furthermore, it lasted for over 20 months. In the past, such divergences between price and breadth have been definite danger signals.

By year-end the stock market was dealing with one of the greatest divergences (separations) between the Dow and the Transports in history. This alone represents a classic red flag for any Dow Theorist.





PTI still below its 89-day moving average, but the early "hints" of a turn are now visible. The little rising trend off the Dec. low must hold, however.

The major stock averages were at record highs while at the same time the bond market suffered one of its worst performances in decades. This is about as rare an occurrence as you're ever likely to see in the markets.

New lows heavily out-numbered new highs for months on end, this in the face of record highs in the big-cap averages. This is something I've never seen before in my 45 years of watching the stock market on a daily basis.

So what's the meaning of all the above? Has the stock market lost its bearings? Is Wall Street suffering from some kind of "millennium schizophrenia"?

Market action is often difficult or almost impossible to decipher at the time it's happening, but eventually, yes eventually, the meaning of the market will become clear.

My own opinion is that there has been a real **change** in the markets of today as opposed to the markets of the past. The change, I believe, has been brought on by the recent and current **massive participation by the public.** With millions of people now having moved into the market, the market has taken on an emotion-charged character that I've never seen before. To put it bluntly, the stock market evolved into what I term the new "Wall Street casino."

As I write this, millions of people are glued to their TV sets while other millions are scanning the stock tables of their daily papers. Well over ten thousand day-traders are bent over their computers as they attempt to beat the market on an hourly or even minute-to-minute basis.

And all the while the stock market is the talk of not only board rooms but bars, beauty parlors, cocktail parties, hotel lobbies -- anyplace where people are gathered. The stock market has become not only the talk of the town but **the talk of the nation,** and the movements of the markets are bigger and more volatile than anything seen in generations.

Current Action: In my Internet report of **December 30** I wrote, "I want to point to something that's occurring on my PTI. I honestly don't know how significant this is, but I want to bring it to the attention of my subscribers. Click back to the daily chart of the PTI. If you draw a descending trendline, starting from the July peak, you'll notice that yesterday the PTI broke ABOVE its descending trendline, this after the PTI has been declining for months. True, the PTI is still well below its 89-day moving average, but the important thing to watch now is whether this is the very beginning of a turnaround in the PTI."

Then in my Internet report of **January 6** I wrote, "Today's action: My PTI was up 6 to 5195, and it looks as though a bottom may be forming. Can't tell for sure yet, but if the PTI can get above 5301 I'd say that the PTI has turned around. No **major** bull signal if 5301 is hit (a major bull signal would require the PTI to rise above its moving average, which today stands at 5235) but at 5301 the formation would look quite promising."

The next day the PTI closed at 5303, and the PTI bottom appeared to be completed. As for me, I'm tossing out all talk, all hype, all the predictions of "experts," and I'm following the path of the PTI. Now, for the first time in many months, the PTI has begun to "walk" up a rising trendline -- it has not issued a major bull signal yet; that will require that the PTI rally decisively above its 89-day moving average. But on a simple trendline basis, the PTI has now turned "early" bullish.

Turn to the PTI chart on page 2. Here's the whole story, and you can see that the PTI has established a rising trend. BUT, and this is CRUCIALLY IMPORTANT -- the PTI must hold ABOVE this new rising trendline. Any break below the trendline would turn the underlying market picture bearish again.

Bonds: In the opinion of most serious analysts, barring a stock market cave-in, the Fed will push rates up another half percent. The bond market is not naive, and I think this half percent is already built into the bond market. But with the stock market still firm or pushing higher, the question is -- why isn't the bellwether 30-year T-bond plunging to new lows?

What I do notice is that on any stock market weakness, the bonds tend to rally. The bond market is relatively sophisticated and the bond market tends to be conservative. The bond market is suspicious of the current "high-priced" market, and it suspects that any market decline, even a decline of a single day, could be the beginning of major stock market trouble.

If the stock market was to turn noticeably weak, the odds are that the Fed would NOT raise rates. That's what the bond market thinks, and that's why the bonds firm on any sign of weakness in the stock market.

INVESTMENT POSITION: Technically the PTI is still bearish since it's still below its moving average. But the PTI is now walking up a rising trendline (page 2 chart) and if this continues we're going to get a bull signal. Thus, I put a very small bear in the box.

With the PTI pushing ever-closer to its MA, you tell yourself that you want to "so something" in the market. Greed is taking over and your head spins. First you have to decide whether you're an investor or a speculator. If you're a speculator, and you have an irresistible urge to speculate, my best advice would be to buy equal parts of SPY, DIA, QQQ, and HHH all on the Amex. I'd hold this combo **as long** as the PTI continues to hold above its current rising trendline.

If you're an investor, you've got a real problem with this market. The problem is that it's the most overvalued market in history. On that basis, it's also a dangerous market. And it's one that true value investors are going to avoid. The best safe values here, in my opinion, are in T-notes going out about five years. For those investors who are patient and who are collecting income, muni bonds offer good value in that you can buy AA-rated bonds to yield better than 6%. **At 6% tax free, money doubles in 12 years.** If you buy the Dow here, can you be sure that it will double in 12 years? Considering that the Dow pays almost nothing in the way of dividends, you'd be depending almost entirely on capital gains. It's a fascinating problem, but the value investor would probably go for muni bonds here -- or the safety of T-bills or short T-notes. After all, from the standpoint of doubling, you're not talking about a 200 Dow yielding 6% rising to 400. Hardly, what you are talking about is an 11600 Dow with a dividend yield of only 1.30% advancing to 22600. You do the math.

NOTES & QUOTES: Russell on the "fabulous AOL Time Warner "merger" (I call it the AOL takeover). This is a case of a company, AOL, with a bloated "stock-scrip" buying out a great, solid company with real earnings, a company with such great assets as HBO, CNN, Warner Bros., publisher of *Time, Sports Illustrated, In Style, People* and with rapid deliverer Road Runner. What has AOL got? "Easy" and slow access to the Internet via phone lines and modems, plus a lot of stuff I can get from the net for free. I subscribed to AOL years ago, but dropped it because I didn't think it was worth the money, and now I know it isn't. Why did Time Warner take the deal? I guess they thought they needed AOL's new net knowledge plus their success in signing up 22 million subscribers. Of course there's also the little fact that the deal shot Time Warner's stock up into the high 90s, but that could change too -- and it has. Hats off to Steve Case for swinging the deal with his bloated 15-year old stock (AOL only went public in 1992). With his hyped-up, high P/E stock, Case bought a great company with paper and no cash. By the way, AOL subscribers pay 20 bucks a month for AOL, but internet access is being offered FREE from more and more companies -- therefore, as I see it, time was running out for AOL. Consider this: AOL's stock was as high as 86 last April. The stock is in the low 60s now. The stock is down 30% from its high. Great company? The market doesn't think so.

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What were the big financial stories of 1999? Here's my vote: (1) The rise of the Internet and Internet stocks. (2) The incredible IPO explosion -- 550 IPOs for the year (and 10,000 mergers). (3) The rise of electronic trading with its accompanying pressure on the Nasdaq and NYSE. (4) Y2K, the great fear and the "nothing" reality. (5) The amazing disparity between the big averages and breadth. (6) The arrival of tens of thousands of day traders. (7) The popularity of momentum trading or buying stocks simply because they are going up.

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Were consumers consuming in 1999? Consider this: De Beers sells two-thirds of all the rough diamond sales in the world through its Central Selling Organization. Two weeks ago De Beers announced a 57% increase in diamond sales in '99 over '98. Second half of the year sales rose 70%. I've always considered diamond sales and prices an excellent measure of consumer confidence. The US now accounts for about 45% of all diamond sales. Prices are sky-high.

* *

HHH, QQQ, BBH, all on the Amex. These three are actually trusts which own the actual shares. QQQ owns shares in the stocks on the Nasdaq 100, and, of course, the Nasdaq 100 includes the 100 largest-cap non-financial stocks of the Nasdaq Composite. The Nasdaq 100 has also been one of the great star performers of the stock market all during 1999. Almost all of the "hot" stocks of the Nasdaq are in the Nasdaq 100. QQQ is traded on the AMEX just like a closed-end fund. You can buy odd lots of QQQ.

HHH (created by Merrill) is the other red-hot item -- it includes 20 leading Internet stocks such as AOL, AMZN, EBAY, YHOO, etc. However, unlike QQQ, if you buy HHH you must buy a round lot of 100 shares.

A third stock in this "series" is BBH, which is the biotech item. BHH contains 20 leading biotech stocks, stocks such as Amgen, Genzyme, Biogen and Genentech. It's a "call" on the biotech industry and it too trades on the Amex.

Should you buy any of these three? I think the prices of the underlying stocks are sky-high, and personally, I'm abstaining. Why? Easy, I just don't have the stomach, and I like to sleep in peace. But, well, help yourself.

* *

Risk: The Dec. 28 *Christian Science Monitor* featured a front page article entitled "America's Growing Affinity for Risk." Says Jackson Lears, a cultural historian at Rutgers, "We're seeing a resurgence of risk both as a necessity of economic success and as a mark of what is fashionable. What's really happening is that risk is now cool." Lears points out that everything from the explosion of the self-help therapy industry with its emphasis on personal "breakthroughs" to extreme sports and gambling as evidence that reverence for taking risks is supplanting society's older preference for control and gradualism.

The article continues, "Indeed take a chance' may be one of the 1990s most significant gifts to the early 2000s. Amazon, and the baby dot-coms that have followed and thrive on a recipe that would have been suspect a decade ago. These Internet start-ups build nothing tangible, borrow gobs of money, and spend generously for years before anyone expects a profit. Yet the stock market and its growing legion of middle-class investors couldn't be more enthusiastic. It's all about betting on growth, which may be perfectly rational but it's also risky. 'What we see is that people don't give enough weight to how imperfect their vision of the future is,' says Meir Statman, a finance professor at Santa Clara University in California. Nonetheless, with more and more common folks automatically pumping retirement dollars into the stock market, acceptance of the market's financial risk is no longer confined to the investor elite. . . And of course one of the industries that has come the farthest the fastest is gambling. Las Vegas is now a family town, and the number of states embracing lotteries has grown exponentially in recent years."

Russell Comment: One of the most fascinating psychological studies concerns the nature of risk. I believe there is a cycle of risk-taking and it coincides with, and grows with, bull and bear markets. Behind risk lie two phenomena, confidence and greed. As a bull market progresses, confidence gradually builds, and towards the top third of a bull market confidence and greed rise exponentially. Finally, confidence and greed explode while all consideration of risk is downplayed to the point where (as we hear now) risk in holding common stocks is considered ridiculous since over the years stocks have outperformed bonds (all you have to do is buy stocks and hold them over the decades).

Being a bit older than most of my subscribers, I've lived through both cycles. I remember the late 1930s and early 1940s where everything was measured against risk, and nobody was willing to take a chance. I've talked about this before. My father was a real estate man. My father and I used to look over "breakdowns" of brownstone buildings on New York's east side. In 1942 you could buy a building, half occupied and providing a net return of 25% a year -- you could buy any number of these buildings for less than $10,000 down. Today these buildings are worth millions. Yet, you couldn't give them away in 1939-42. Nobody was willing to take a chance.

Compare that with the psychology of today where venture capitalists pump millions into dot-com companies, many of which are mere concepts, companies that admittedly won't be profitable for years. Yet today confidence and willingness to take risks is almost unlimited. The difference between the psychology of 1942 and 1999 is miles apart. Will confidence remain the dominant psychology well into the new millennium? Anything is possible, but my feeling is that the cycles of change are still with us.

An old stock market "rule" states that a stock should sell at a price-earnings ratio roughly comparable to its growth rate. Let's take Microsoft as a current example: analysts believe that MSFT will grow at a 25% rate over the next five years (that seems excessive to me, but I'll go along with that figure). If MSFT were to sell at a P/E ratio of 25, the stock would now sell at 35, not 117.

If this same formula were applied to other "hot" growth stocks such as CSCO, QCOM, INTC, WCOM, we'd have a major collapse in the Nasdaq and S&P. By the way, MSFT, CSCO and INTC, those three account for 24% of the total value of the Nasdaq.

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Not all Nasdaq stocks did well last year. There are 4,575 stocks in the Nasdaq: of those, 2,061 actually closed down for the year 1999. Another extraordinary figure: 80% of

the stocks within the Nasdaq rose less than the Nasdaq Composite did. The reason is obvious -- a small number of Nasdaq leaders controlled the price of the Nasdaq.

* *

Major trends are often not understood, even though they are there in plain view. Example: this article appeared on the front page of the **September 5 1994** *Los Angeles Times*. If we (you and I) had understood the implications of this article and acted on it, we'd be -- well, multi, multi-millionaires.

At 25, Internet Readies Move Into Free Market

■ Technology: Quasi-public computer network will be privatized. Some are leery, others see opportunity.

By AMY HARMON
TIMES STAFF WRITER

For 25 years, from its founding by the Defense Department as a tool for the scientific elite to its recent astounding growth like some ferocious strain of fiber-optic ivy, the amorphous computer network known as the Internet has been anchored financially and technologically by the federal government.

Not anymore.

As the 'Net celebrates its silver anniversary this month, the National Science Foundation—which has been spending upward of $10 million a year administering the central "backbone" of the Internet—is preparing to relinquish the world's closest thing to an information highway to the vagaries of the free-market.

have a center," said Bill Washburn, who heads a consortium of smaller networks that is one of many entities hoping to profit from the new Internet order.

"The Internet is anarchy, it's a form of chaos, and with the disappearance of the NSF network, that chaotic quality will become more immediate and more evident to a lot of people who have been able to ignore it."

Please see INTERNET, A16

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Jeff Bezos, the CEO and founder of Amazon.com, is everywhere. He made the cover of *Time* magazine a few weeks ago ("Person of the Year"), he's interviewed extensively in Playboy this month. He's everywhere. And I wonder if he's receiving too much publicity as the head of a huge e-tailer, a company that loses money the more it sells. Amazon is the biggest online retailer, and as such I watch it with interest. AMZN shows a double-top at the 110 area. Recently AMZN has dropped below its 34-day MA, and the stock is now closing in on its 144-day MA, which stands at 73 ½. Conclusion: On the chart, AMZN looks to me as though it has topped out. It's now well below its 200-day moving average.

* *

The electronic revolution is hitting the "old" exchanges. The Philadelphia Exchange, which draws 80% of its business from options, has seen the price of a membership seat drop from $305,000 in April 1998 to $65,000 in mid-December. At the CBOE, the largest options exchange, the price of a seat has fallen from $700,000 a year ago to $450,000. At the Amex a seat has fallen from $670,000 in mid-May to $395,000.

* *

Greed? Kim Polese is a very rich, successful entrepreneur. She's one of the few female executives in Silicon Valley. Kim is co-founder of Marimba, a 1999 IPO which soared as high as $1.4 billion in market value. In a recent interview in the *WSJ*, here's a bit of what she said: "I think there will be a backlash against all the greed. I think people are going to just get fed up and realize that it's not fulfilling. I look around me, and I have so many friends who started companies who are worth $50 million and more, and they are depressed. They think they've made it, and they take six months off and they realize that they're more depressed than ever. Because this wasn't really what ultimately it turned out that life was all about. I look around me, and I see unhappy billionaires, and I see them coming back again and again to start another company. And what really attracts them is connecting with other people. It's the team. It's creating something. It's having a mission. That's what turns people on. That's what life's all about."

* *

E*trade Group offered one million dollars to anyone who could guess where the Dow would close in 1999. A total of 350,000 people entered the contest. One person won -- Robert Tokarcheck, a retired civil servant from California. He predicted that the Dow would end the year at 11497.72; he got it right to the penny. How did he do it? Tokarcheck confessed, "I came up with the number in about five minutes," and he added that he didn't base it on any kind of market analysis. **Russell Comment:** Great luck will beat genius every time.

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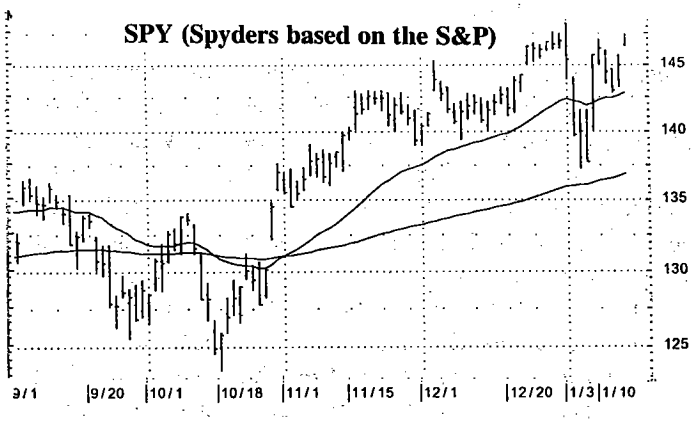
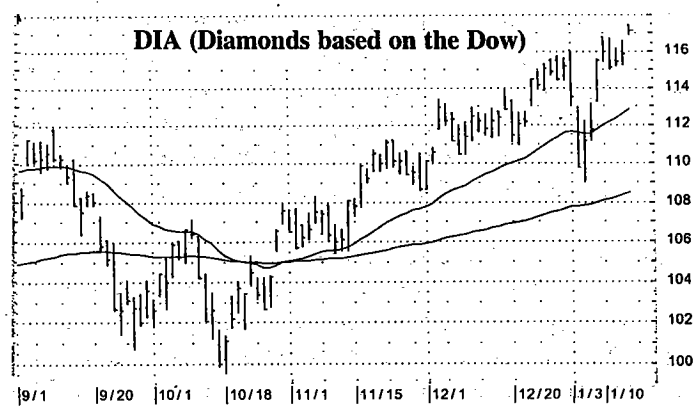
Quote of the Month: From Mayor Giuliani who was asked how he'd feel if he was elected senator from New York and had the Clintons as constituents: "I feel very, very proud about the fact that people from all around the country want to come to New York, including people from Arkansas."

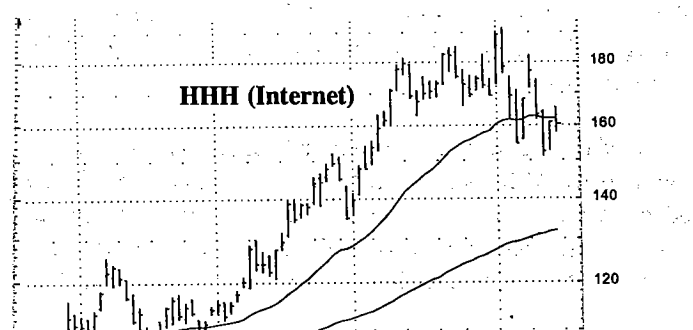
HOW TO PLAY: With my PTI moving closer and closer to its bullish mode, speculators (you're not investing here) are wondering what they can do that makes any kind of sense. My answer is that the most intelligent and the most liquid "play" here is simply to buy the "index" funds that are listed on the Amex. So saying, let's take a look at what they're doing. After all, if the markets are going to advance from here, the sensible path is to buy the markets.

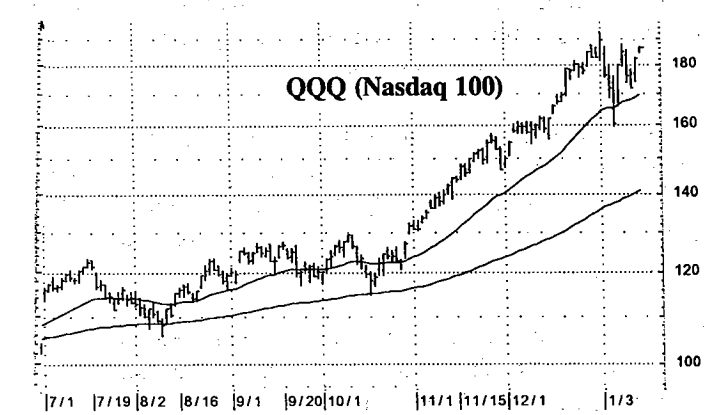
The first chart (page 6) show the Spyders (SPY), a stock which indexes itself to the S&P. The chart is clear enough. The Spyders are in a strongly bullish mode with the SPY above the 34-day MA and the 34 in turn well above the 144-day MA.

The stock that is indexed to the Dow is the Diamond (DIA), also on the Amex. The picture here is much the same as the Spyders. Clearly a bullish picture.





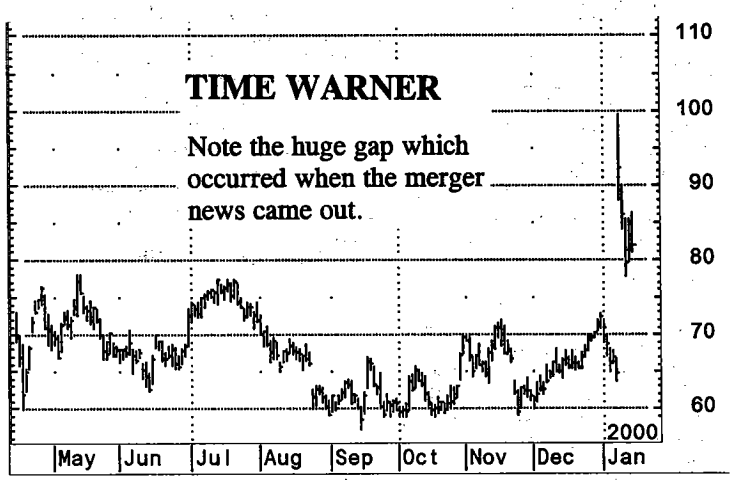




The third chart shows HHH, a collection of 20 leading Internet stocks. This is a Merrill "invention," and it also trades on the Amex. This stock looks just a bit toppy, and it's flirting with its 34-day MA. As long as HHH is above 151, I'd consider the trend as bullish. The 34-day moving average is just beginning to decline. The picture here is questionable.

Finally I show QQQ (Amex), a proxy for the hottest area of the market so far, the Nasdaq 100. This stock is clearly bullish.

Personally, I prefer any of the above to mutual funds. These stocks pay no dividends, they have no built-in tax liabilities, they represent a pure play on market action. And let's be honest, that's all you're doing when you buy stocks today. Today stocks pay little or no dividends, they're wildly overpriced -- buying stocks here is just a play on continuing upward momentum. Buying the index stocks eliminates the problem of picking the right stock.



AOL TIME WARNER: This is a fascinating merger, and it's being written up as one of the seminal mergers of all time. Great, that may be true, but what fascinated me is the price **action** of the two stocks. AOL hit a high of 83 back on April 27. Last week it closed at 63, down 24% from its high. Mmmm. On the merger news Time Warner (TWX) surged to a high 991/2 (Jan. 10), but since then the stock has declined to 82 on Jan. 14 -- in this action TWX lost almost half of its merger gains. In fact, back on May 12 TWX was 77 ½, so TWX as of Jan. 14 was only 5 points higher than it was eight months ago. What is the market saying? Let me put it this way -- it seems to me that the market is questioning the deal. The action coming up on these two stocks should be fascinating.

Fortune: Beg, borrow or steal the January 24 issue of *Fortune* magazine. It contains a terrific article entitled, "Has the Market Gone Mad?" This is one of the best, and most intelligent articles I've read on the current market and its pricing. A real gem.

NEXT MAILING: February 9, 2000